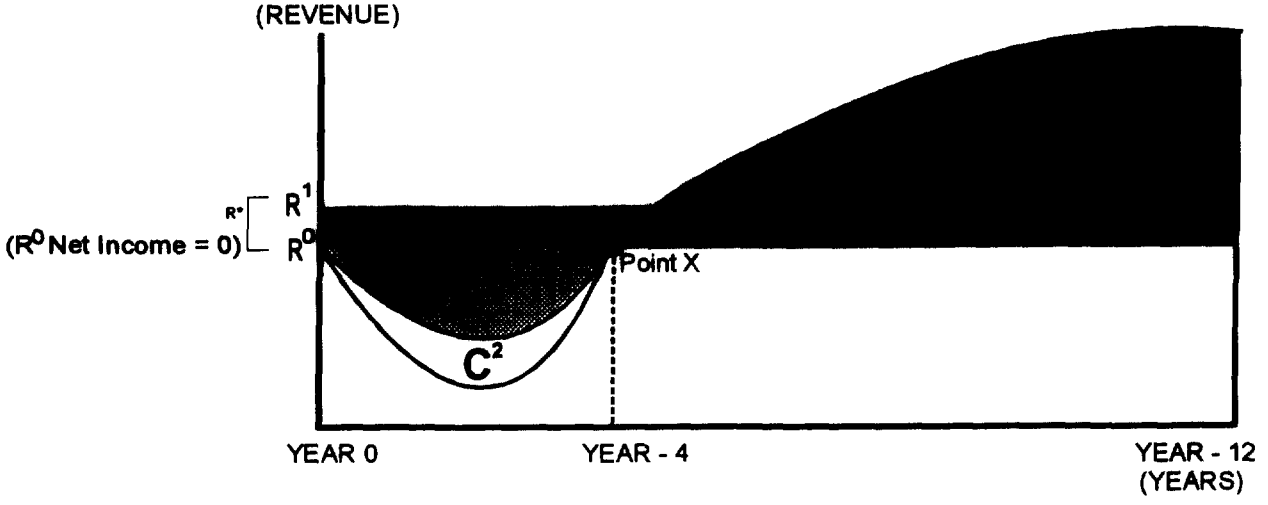
F. A Graphic Look Demonstrating Why Cable Operators Must Be Permitted To Include Their Unrecovered Expenses In Their Rate Base.

Perhaps a visual tool may prove helpful to understand not only the distinction between regulated utilities and cable operators just now entering a regulated environment, but also the necessity that cable operators be allowed to include in their rate base all of their unrecovered expenses. Figure 1 compares the 12-year investment cycle of a cable television operator initiating service to the investment cycle of a previously regulated and established utility over the same period of time in terms of net revenue. 20/

20/ We include Figure 1 for illustrative purposes only. While Figure 1 demonstrates the inherent dangers of treating cable operators and regulated utilities the same for rate base purposes, we make certain assumptions for ease of illustration that are not necessarily applicable to all cable operators. For example, we are not suggesting that the average cable operator has positive net income after only four years. In fact, many cable operators (in particular small systems operators) have been and will be operating at a loss well past the fourth year of operation. Figure 1 also does not include a component reflecting construction costs because both regulated utilities and cable operators incur these costs, include them in their rate base, and depreciate them over the useful life of the plant. Rather Figure 1 focuses upon those components that cable operators must defer recovery of until such time that they achieve a positive net income, in contrast to established public utilities.

FIGURE 1

The Twelve-Year Investment Cycle
For Cable Television Operators



Legend to Figure 1

A = Regulated Utility's Return On Investment From Year 0 to Year 4.
B = Regulated Utility's Return On Investment From Year 4 to Year 12.
C^1 = Cable Television Operator's Deferred Start-Up Costs.
C^2 = Cable Television Operator's Interest On Deferred Start-Up Costs and Construction Costs.
B + D = Cable Television Operator's Return On Investment Plus Recovery Of $C^1 + C^2$. B + D equals A + B + C^1 + C^2 Plus Return Increased By Risk For Investing In Cable Television.
Point X = Net Income (Revenues - Expenses) Equals 0.
R* = Amount of Annual Net Revenue (Return) Received By Regulated Utility.

The vast majority of public utilities and communications common carriers have been operating for decades as regulated entities. There is no issue concerning their ability to generate sufficient revenues to cover their start-up expenses. They achieve every year the profits authorized by the regulatory authorities. As demonstrated in Figure 1, throughout the cable operator's investment cycle, the regulated utility recovers through its rates that amount of revenue sufficient to cover not only all of its expenses (i.e., that amount of revenue necessary to achieve a net income of zero -- **Point R^0**), but also earn an amount representing a return on the investment in its system (**Point R^1**). The amount of return on investment the regulated utility receives each year is represented by **Area R***. Accordingly, the regulated utility will have a cumulative return on the investment in its system from Year 0 to Year 4 of **Area A**, a cumulative return on

the investment in its system from Year 4 to Year 12 of **Area B**, and a total return during the 12-year cycle of **Areas A** plus **B**.

Unlike the regulated utility, the cable operator has deferred expenses (**Area C^1**) that it is unable to recover during the start-up phase of its operations. See Section IIB. In addition, during the start-up phase of its operations, the cable operator has not recovered the interest it paid to borrow funds necessary to construct the system and cover losses during the start-up phase (**Area C^2**). See Section IID. Accordingly, from Year 0 until Year 4 (the date when the cable operator's net income equals zero (**Point X**)), the cable operator has unrecovered expenses of **Areas C^1** plus **C^2**,which it is entitled to recover in its rate base.

During the remaining 8 years of the investment cycle, the cable operator must recover not only its deferred start-up costs (**Area C^1**) and unrecovered interest costs (**Area C^2**), but also a return on its investment reflecting the higher risk associated with investing in the cable industry as opposed to more established utilities. In order to recover its deferred start-up costs and interest (**Areas $C^1 + C^2$**), plus a fair return, the cable operator must receive from its subscribers during the remaining 8 years of the cycle that amount of revenue equal to the revenue designated in **Area B**, which the regulated utility would receive as a matter of course during the remaining 8-year period, plus the revenue designated in **Area D**. The amount that the cable operator must be permitted to recover after Year 4 (**Areas B + D**) should be equal to the return the utility recovered in Years 1 through 12 (**Areas A + B**), plus the losses and interest expenses (**Areas $C^1 + C^2$**), plus some greater return than the utility is permitted to reflect the increased risk of entering the cable business.

We recognize that during the period prior to achieving a positive net income (**Point X**), the cable operator has foregone the return (**Area A**) that the

regulated utility received on its investment. However, the cable operator would retrieve at least a portion of that foregone return (**Area A**) by recovering the interest it paid on its deferred start-up costs and construction costs (**Area C**[2]) after it achieved a positive net income. If the FCC does not permit the cable operator to include in its rate base both its deferred start-up costs and interest on its deferred start-up and construction costs, the FCC would be locking the cable operator on a going forward basis into the same return as the regulated utility which has already recovered these costs. In essence, cable operators would be asked to forego the revenue in **Area B**. 21/

For purposes of illustration, we have chosen to compare a newly-constructed cable system with an established utility company. Of course, some cable systems are well beyond the start-up phase and have fully recovered their deferred start-up costs, etc. Where these deferred costs have been recovered, they are not an issue. On the other hand, some utilities (though few) have recently gone through a start-up phase. And in those cases, they have been permitted to recover their start-up costs. See, e.g., Comsat, 611 F.2d at 895-96. The point of the illustration is to emphasize that where cable operators have unrecovered start-up costs, they must be permitted higher revenues in the later years of their investment cycle in order to earn their required return.

Cable operators have not been able to earn sufficient revenues to cover their start-up costs in the early years of operation, even in an unregulated

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21/ As we noted earlier, many cable operators traditionally have had to defer their return on investment until the time the system was sold. The rates set for regulated utilities, however, contemplate a profit every year and do not include any expectation of a "residual value." Once cable television rates are regulated, the old valuations for cable systems will no longer apply, and no longer will cable operators be able to assume that their profit can be obtained through a sale of the asset. Any profit that can be obtained will likely be the result of the buyer's confidence in future unregulated revenues.

environment, because cable service is not an "essential" service and demand is relatively elastic. As recognized by the FCC, see, e.g., Comsat, 611 F.2d at 895-96, and other regulatory bodies, see, e.g., St. Lawrence Gas Co., 42 N.Y.2d 461, 368 N.E. 2d 1234, 1236 (N.Y. 1977), Stan-Fran Corporation, Docket #AFD-10 and #AFD-2 (Mass. Comm. Antenna Tel. Comm. 1976), charging rates high enough to cover all early year expenses when they are incurred would not permit cable operators to acquire enough subscribers to survive.

III. Cable Operators Are Entitled To Justify Their Current Rates By Including Their Full Acquisition Costs In Their Rate Base.

The FCC recognizes that in an unregulated environment many cable operators purchased cable systems as ongoing businesses at prices exceeding the depreciated original cost of the plant in service. NPRM at ¶ 36. While the FCC tentatively has concluded that excess acquisition costs should be excluded from the ratebase, it appropriately recognized the need for a transition mechanism to assist cable operators as "they adapt to a rate regulated environment." NPRM at ¶ 22. 22/

22/ There is no indication that Congress intended that the FCC prevent cable operators from recovering fully their investments in their systems, including their full acquisition costs. NPRM at ¶ 37. Congress never suggested that the 1992 Cable Act should strip cable operators of any part of their initial investment in their cable systems. To the contrary, the legislative history is filled with statements regarding the benefits resulting from cable operators' substantial investments in the cable industry, that cable operators are entitled to the enhanced value of their systems, and the need for cable operators to fully recover their costs. For example, in its Report, the House Committee on Energy and Commerce reminded the FCC that it "should recognize that the basic service tier constitutes only a portion of the cable operator's overall business . . . and that other benefits, in forms such as enhanced asset value . . . accrue to the cable operators." H.R. Rep. No. 102-628, 102d Cong., 2d Sess. 29, 83 (1991) (emphasis added). Recognizing their substantial investment and their right to recover the "enhanced value" of their systems, the Committee stated its intention that the FCC "allow cable operators a full recovery of their costs" in addition to a "reasonable profit." Id. at 82.

Even though the FCC considers it the traditional practice in rate regulation to disallow excess acquisition costs, the Commission understands that it is appropriate in some cases to allow such costs, particularly where "company policy has resulted in expense recognition of expenditures that produced value." NPRM at ¶ 39. We believe that cable operators should be allowed to include in their rate base their entire acquisition costs, as a transition mechanism, to justify their current rates. Indeed, the need for the allowance of acquisition costs in the rate base is particularly compelling "in view of the transition of the industry from a nonregulated to a regulated environment." NPRM at ¶ 39.

There are strong Constitutional arguments that cable operators, whether they purchased or built their systems prior to regulation, are entitled to include in their rate bases their entire investment in their systems. 23/ Under the Fifth Amendment to the Constitution, cable operators are entitled to rates that provide an opportunity for the regulated entity to recover sufficient revenues to "assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital" as well as "compensate its investors for the risks assumed." Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603 (1943); see also Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254, 1260 (D.C. Cir. 1993). It is constitutionally impermissible for the FCC to set rates which would interfere

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23/ The 1992 Cable Act reaffirms that the rates set for basic service must be "reasonable" and that the rates set for tiered service must not be "unreasonable." In any event, any standards by which the FCC sets cable rates must comply with the Constitutional requirements and, by long standing usage in the field of rate regulation, the "'lowest reasonable rate' is one which is not confiscatory in the constitutional sense." See Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 585 (1942); see also Duquesne Light Co. v. Barasch, 488 U.S. 299, 307-08 (if regulated rates are so low as to be confiscatory, an unconstitutional taking occurs).

with the reasonable investment-backed expectations of those persons who have invested in the cable industry.

While some courts have not permitted public utilities to include their full acquisition costs in their rate base, 24/ the public utilities involved in those cases had always been subject to regulation. The acquiring utility knew that the acquired utility's rates had been, and would be, regulated on the basis of a regulated rate base that might not include all of acquisition "premiums."

Clearly, where a cable system has been constructed prior to its rates being regulated, 25/ there can be little question about the reasonableness and prudency of the construction because there was no incentive in an unregulated environment to construct needless facilities or to otherwise "pad" the ratebase. Similarly, where a cable system has been acquired after construction, so long as the acquisition price was arrived at in an arm's length transaction and represented the fair market value, the investors may not be deprived of the opportunity to earn a reasonable return by intervening regulation. The FCC previously has recognized that it should not second-guess such investments made in a non-regulated environment. See 1991 Rate Base Decision, 7 FCC Rcd at 299. At the very least, as

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24/ See, e.g., Harrisburg Steel Corp. v. Pennsylvania Public Utility Commission, 170 Pa. Sup. Ct. 550, 109 A.2d 719 (1954). But a number of state public utility commissions have permitted utilities, which were regulated prior to their acquisition, to amortize their acquisition costs, see, e.g., Board of Supervisors v. Virginia Electric & Power Co., 196 Va. 1102, 87 S.E. 2d 139 (1955), as has the FCC, 1991 Rate Base Decision, 7 FCC Rcd 299.

25/ In those relatively few jurisdictions where rates may have been regulated during construction, the regulating authorities presumably have already had an opportunity to rule on the prudency of the investment. Where no issue was raised earlier, it seems clear that no issue can now be raised merely because the format for regulation had changed.

a transitional measure, 26/ cable operators must be allowed to justify their pre-regulation rates on the basis of a rate base which includes the entire acquisition cost (depreciated and amortized since the acquisition) for acquisitions made in arm's length transactions prior to regulation. If justified based upon acquisition costs, the cable operators' rates then could be regulated under the FCC's price caps.

The FCC has addressed the manner in which acquisitions in an unregulated environment should be treated for rate base purposes. In its 1989 Rate Base Decision, 4 FCC Rcd 1697, 1705 (1989), the FCC found that, as a general rule, adjustments to a carrier's rate base arising from its purchase of regulated carriers (plant "with traffic") requires a higher degree of justification than adjustments arising from the purchase of unregulated carriers (plant "without traffic.") 27/ . But on review in Illinois Bell Tel. Co. v. FCC, 911 F.2d 776 (D.C. Cir. 1990), the D.C. Circuit found that the FCC had not justified adequately its presumptive exclusion of acquisition adjustments involving a carrier's purchase of plant "without traffic" from a non-affiliated carrier, reasoning that there was no reason for

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26/ In its NPRM, the FCC recognized that "an equitable balancing of consumers' and cable operators' interests may require an allowance in ratebase of some excess acquisition costs in view of the transition of the industry from a nonregulated to a regulated environment." NPRM at ¶ 39. Accordingly, the FCC concluded that it might allow cable operators to include in their rate bases their excess acquisition costs to the extent they can demonstrate a need to allow such excess acquisition costs as a transition mechanism. NPRM at ¶ 40.

27/ For the purposes of considering acquisition adjustments involving common carriers, the FCC distinguishes between telecommunications plant purchased with and without "traffic", i.e., the right to provide service to customers of the seller who were formerly served by the plant. 1989 Rate Base Decision, 4 FCC Rcd at 1705, 1709, n. 39. In essence, plant without traffic (i.e., without customers) is unregulated because that plant has no customers whose rates are subject to regulation. Accordingly, a common carrier's acquisition of plant without traffic is an acquisition of an unregulated entity similar to the acquisition of a cable system prior to rate regulation.

assuming that the acquisitions were not at "fair value." On remand, the FCC altered its stance with respect to plant acquisition premiums paid to non-affiliated carriers for plant "without traffic" by allowing inclusion of the full cost of the plant acquired in the acquiring carrier's rate base. 1991 Rate Base Decision, 7 FCC Rcd at 299. In allowing full acquisition costs in the carrier's rate base, the FCC determined that "such transactions should be treated no differently than any other arm's length transaction with a non-affiliate [because] when the price of an asset is determined by an arm's length transaction in the normal course of business . . . there is a reasonable assurance that the price paid would not be manipulated to the detriment of the ratepayers." Id. If the FCC allows common carriers to include their full acquisition costs in their rate bases when they purchase unregulated carriers, it similarly must allow cable operators to include their full acquisition costs in their rate bases when they purchased previously unregulated systems.

Including full acquisition costs in the rate base where the acquisition was outside of a regulated environment is also consistent with an "original cost" methodology. All definitions of "original cost," including the FCC's definition, recognize that the cost be the one incurred at the time the property was dedicated to use by a public utility, not the cost of the property at some earlier time. The FCC defines original cost as "the actual money cost of (or the current money value of any consideration other than money exchanges for) property at the time when it was first dedicated to public use, whether by the accounting company or by a predecessor public utility." Federal Communications Commission, Uniform System of Accounts Prescribed for Public Utilities and Licensees, 47 C.F.R. § 34.02-1 (1993). Other regulatory commissions have defined original cost similarly. For example, the Federal Energy Regulatory Commission's definition, with respect to electric plant, states that "'original cost,' as applied to electric plant, means the cost of such

property to the person first devoting it to public service." Federal Energy Regulatory Commission, Uniform System of Accounts Prescribed for Public Utilities and Licensees, 18 C.F.R. § 101(A)(3)(1993). 28/

Cable operators traditionally have not been considered public utilities. See S. Rep. No. 102-92, 102d Cong., 1st Sess., p. 73 (1991)("there is no history for establishing rates for cable service that is analogous, for example, to the process used in the telephone industry"). Thus, even under the FCC's traditional reliance on "original cost," acquisition prices must fairly be included in the rate base, at least as a transition matter.

IV. Cable Operators Are Entitled To Include In Their Rate Base That Portion Of Their Acquisition Cost Represented By The Depreciated Reproduction Cost Of The System, Plus Start-Up Costs, As Well As That Portion Attributed To Operating Efficiencies.

A. The FCC Should Permit Cable Operators In All Circumstances To Include In Their Rate Base That Portion Of Their Acquisition Price Represented By The Depreciated Reproduction Cost Of The System, Plus All Estimated Start-Up Costs.

In all cases, either to justify current rates or rate increases, the FCC must permit cable operators, at a minimum, to recover that portion of their acquisition costs that represents the full (i.e., reproduction) cost 29/ of building the

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28/ Commentators similarly have defined "original cost" as the cost of the plant when it was first devoted to public service. See, e.g., A. J. G. Priest, Principles of Public Utility Regulation, p. 75 (1969)(for rate base purposes, courts define "original cost" as the "cost to the person who first devoted [the property] to public use"); M. Farris & R. Sampson, Public Utilities: Regulation, Management & Ownership, p. 141 (1973)("original cost" is the cost of utility plant "to the person first devoting it to public service").

29/ We think it is necessary to utilize a "reproduction cost," as opposed to an "original cost," approach in estimating the current value of the plant cable operators acquired because requiring them to rely upon the original cost figures of former owners would, in many instances, leave them without any way to calculate a rate base. As we pointed out earlier, because they were not required to keep records of

system at the time of acquisition (less depreciation reflecting the system's age) and covering the early-year losses necessary to achieve viability. 30/ The concept of permitting cable operators to include the reproduction cost of their system in their rate base is neither new nor novel. In fact, there is considerable precedent for allowing regulated entities to include the reproduction cost of their facilities in their rate base. Driscoll Edison Light & Power Co., 307 U.S. 104 (1939); McCardle v. Indianapolis Water Co., 272 U.S. 400 (1926); Bluefield Water Works & Improvement Co. v. West Virginia Public Service Commission, 262 U.S. 679 (1923); Wilcox v. Consolidated Gas Co., 212 U.S. 19 (1909).

In this case, we believe that any cable operator is entitled to include in its rate base that portion of its acquisition cost that represents what it would cost to replace its facilities and overcome operating losses in the start-up phase. In our view, this is a rock-bottom method to measure value. Even Shooshan & Jackson, in their criticisms of the acquisition price of cable systems, use depreciated replacement cost as their estimate of minimal value. See "Opening the Broadband Gate." 31/ Thus, our recommendation employs the basic analysis of some of the

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the original cost of their systems (particularly where the system has been sold several times), many cable operators simply would have no way of knowing what the "original cost" of their plant is. In situations where original cost information is not available, public utility commissions often have utilized a "reproduction cost" approach in determining the current value of plant.

30/ Permitting cable operators to include in their rate bases their full acquisition costs to justify existing rates (Section III), while also permitting them to include in their rate bases a portion of their acquisition cost based upon the reproduction cost of their plant to justify either current rates or rate increases (Section IV.), is consistent with the FCC's proposal of one valuation methodology for determining initial regulated rates and another methodology for assessing proposed increases under subsequent cost-of-service showings. NPRM at ¶ 33.

31/ The Senate similarly relied upon replacement cost as the minimal value of a cable system. In observing that the acquisition prices for cable systems had tripled since the 1980s, the Senate noted that these acquisition prices far exceeded the

industry's toughest critics. But it is clear that some recognition must also be made of what additional money would have to be raised to bring the system to viability. As noted above, all cable operators are entitled to a rate base that also includes unrecovered start-up costs and that defers depreciation until revenues are sufficient to cover all operating expense. Thus, the minimum reasonable purchase price for any cable system (and thus the minimum portion of an acquisition price that should be included in the rate base) is the cost that would be required to reproduce the cable system (less depreciation reflecting the system's age) in substantially its present form at current price levels plus the deferred costs that would be incurred by the cable operator in launching service. Based on an extensive database available to Mr. Kern, he has constructed cost-of-service models to calculate reproduction costs (based upon, among other things, the mileage of the system, whether the plant is above or below ground, and the number of channels). Mr. Kern has also constructed a model that calculates the amount of money that the cable operators would have to raise to meet start-up losses.32/

Perhaps another way to view this minimal valuation of an acquired cable system is that it is the lowest possible calculation of the portion of the

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replacement value of the cable systems. See S. Rep. No. 102-92, 102d Cong., 1st Sess. 10 (1991).

32/ The reproduction cost of a cable system could be calculated in a number of ways including, but not limited to, appraisals, estimates of the cost of equivalent new facilities less the appropriate deductions for depreciation necessary to account for the fact that existing facilities are not new, or by the original costs of existing facilitates adjusted upward or downward by price indices reflecting price changes since the acquisition of the particular assets of the utility. See Paul Garfield and Wallace Lovejoy, Public Utility Economics, Boston: Prentice Hall, p. 62 - 63 (1978). While Mr. Kern's models provide a methodology to calculate the reproduction cost of cable plant based upon industry averages, cable operators should also be allowed to substitute their own recent actual cost estimates in calculating the reproduction cost of their own system.

acquisition price which is "used and useful" to subscribers. As noted above, there are strong reasons to include the entire acquisition price in the rate base, where the purchase was at arm's length in an unregulated environment. But, at the very least, no one planning to enter the cable business in the community of acquisition could expect to have to raise less money than reproduction cost, plus an amount necessary to cover early losses, as well as interest necessary to carry the project until it reaches profitability.

B. Cable Operators Also Are Entitled To Include In Their Rate Base That Portion Of Their Acquisition Costs Attributed To Operating Efficiencies.

Either to justify current rates or a rate increase, we also think the FCC should permit cable operators to include in their rate base that portion of "excess" acquisition costs which would generate a return to the cable operator equivalent to any operating expenses they have been able to save their subscribers through efficiencies related to the acquisition. The FCC notes in its NPRM that cable subscribers may benefit from an acquisition in those situations where the acquiring cable operator is able to realize operating efficiencies. NPRM at ¶ 36. Assuming that the acquiring cable operator has been able to reduce the operating costs per subscriber by operating efficiencies and increasing the subscriber base, the amount of revenue required from each subscriber to meet these expenses in a cost-of-service showing is reduced. Due to the benefit to the subscribers resulting from these operating efficiencies, we think it is only fair (not to mention a way to motivate operators to operate even more efficiently) to allow operators to include in their rate base at least that portion of an acquisition adjustment that would generate revenues equal to the saved expenses.

Consistent with this approach, numerous decisions have emphasized that portions of acquisition premiums may be included in the rate base where there

was some benefit to consumers. 33/ Indeed, courts and public utility commissions have often found it appropriate to include an acquisition adjustment in the rate base where (1) the purchase price was reasonable, (2) the sale and purchase of the property was conducted at arm's length, and (3) the purchaser's acquisition of the property benefited the customers acquired with the system. See, e.g., Re Indianapolis Water Co., 75 PUR4th 643 (Ind. PSC. 1986). While it has refused to use a "balance sheet" analysis to determine what costs should be included in the rate base, Illinois Bell Telephone Co. v. FCC, 911 F.2d at 778, the FCC itself has expressed a willingness to permit utilities to include some acquisition adjustment in their rate base where there was some showing that the public has benefited from the acquisition. 1991 Rate Base Decision, 7 FCC Rcd at 299. 34/

33/ Numerous courts and commissions have allowed public utilities to include all or a portion of their acquisition costs in their rate base where there was a showing that the acquisition directly benefited subscribers. For example, in Re Peoples Gas Systems, Inc., 119 PUR4th 252 (1990), the acquiring utility was permitted to include a portion of its acquisition price in its rate base due to various benefits to the acquired utility's customers including (1) increased quality of service, (2) lowered operating costs, (3) increased ability to attract capital for improvements, (4) a lower overall cost of capital, and (5) more professional and experienced managerial, financial, and technical personnel. Similarly, in Re Northeast Utilities Public Service Co. of New Hampshire, 114 PUR4th 385 (1990), a portion of the acquisition price was permitted in the rate base because the acquiring utility (1) could operate acquired assets as an integral part of its existing system, (2) could provide capital to finance operation of the system; and (3) had necessary engineering, accounting and other management services to operate the system efficiently and economically. Finally, in Re Interstate Power Co., 81 PUR4th 471 (Iowa PSC 1987), the utility was permitted to include a portion of its acquisition cost in the rate base because it demonstrated the following benefits: (1) avoidance of alternative capacity costs; (2) the sale price of the existing station was lower than what it would cost to construct new station; (3) the existing station was modern and efficient; and (4) it cost less to operate the existing station than alternative stations.

34/ We suggest that the method by which cable operators can demonstrate that an acquisition benefited their subscribers is to compare the operating costs per subscriber before the acquisition and at the time of the cost-of-service showing.

V. The FCC Must Make Special Consideration for Small Systems.

The FCC recognizes in the NPRM that small systems demand special attention. Because of the typically higher costs and the especially heavy weight of administrative costs on small systems, Congress has instructed the Commission to design rate regulations that "reduce the administrative burdens and cost of compliance for cable systems that have 1,000 or fewer subscribers." Section 623(h). We urge the Commission to permit small systems (1) to utilize a basic "net income" analysis to justify their current rates (subject to the price cap requirements), (2) to use a streamlined cost of service analysis with fewer expense categories, and (3) to use their consolidated accounting structures in all rate analyses.

In its Petition for Reconsideration in this proceeding, the Coalition proposed a net income analysis, by which systems with less than 1,000 subscribers would be deemed to have reasonable rates if their net income margin is less than 15.5 percent. The net income analysis represents a primitive cost-of-service approach, in which operating expenses, depreciation and interest expense are subtracted from operating expenses, yielding the net income margin. This simplified, first-step analysis would serve to protect those very small systems with a reasonable amount of net profits (or net losses) from the considerable administrative burden of a benchmark analysis or a full-blown cost-of-service analysis.

Assuming that the acquiring company has been able to reduce the operating costs per subscriber by operating efficiencies and increasing the subscriber base, the amount of revenue required from each subscriber to meet these expenses in a cost-of-service showing is reduced.

The net income analysis for systems with less than 1,000 subscribers furthers the statutory goal of providing relief from administrative burdens for these small systems. Moreover, because only those small systems with net income margins of less than 15.5 percent would be excused from further regulation under the net income analysis, there is no danger that systems reaping unreasonable profits would benefit from the exclusion. Also, operating expenses, depreciation and interest expense are the only items that the Coalition proposes to subtract from gross revenues under the net income analysis -- amortization was intentionally not included in the items to be subtracted from gross revenues, in order to avoid the potential for controversy about treatment of intangible assets.

The net income analysis is to be used as a transitional matter only. 35/ Small cable systems would complete the proposed net-income form (Exhibit 4), based on their accounting records prior to April 1, 1993. 36/ Those cable systems showing net income of 15.5 percent or less would not be subject to other rate regulatory requirements, such as unbundling of equipment. But the net income analysis would be used only to justify current rates under price cap regulation. Later price increases would be limited to increases permitted under the price cap rules. See Coalition Petition for Reconsideration (filed June 21, 1993).

Small systems whose rates are not shown to be reasonable under the net income analysis should be permitted to use streamlined cost-of-service methods to demonstrate the reasonableness of their rates. Some small systems may have plant that is largely depreciated or may not significantly use debt

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35/ See footnotes 6 and 11, supra.

36/ We suggest that the analysis be based on data compiled prior to April 1, 1993, to avoid any issue of companies revising their accounting, or refinancing specifically to create additional interest expense under the net income analysis.

financing. Yet these systems may still be able to justify their rates -- and perhaps rate increases -- under a more complete cost-of-service analysis than presented by the net income approach. As explained in Mr. Kern's Declaration, he has simplified and streamlined his cost-of-service model for small systems. See Kern Declaration at p. 1. The model operates in the same way as does his model for larger systems, except that it consolidates various cost accounts.

As a first step in streamlining cost-of-service procedures for small systems, it is critical for the Commission to permit small operators to undertake cost-of-service analysis on a consolidated accounting basis. As a general matter, the Small System Operators do not maintain accounting records at the system level. Instead, books are maintained on a consolidated basis for groups of systems. The practice of maintaining books on a consolidated basis is necessary for purposes of efficiency -- it simply does not make sense for operators to try to maintain separate books for every town with a few dozen subscribers, or even for a group of towns or collections of small systems.

Furthermore, it would be unnecessarily burdensome for small systems to have to allocate costs and revenues in order to derive figures that could be used for a franchise-level or system-level cost-of-service analysis. Instead, small systems should be permitted to rely on their existing consolidated accounting numbers to demonstrate that they are not making more than a reasonable profit. The utilization of consolidated accounting figures will not exempt small systems from the substantive provisions of the cost-of-service rules. Indeed, the small system operator that can demonstrate with consolidated financial information that all of its systems in a consolidated accounting system combined do not reap more than a reasonable profit should clearly not be made to reduce its rates. Thus, there is no reason not to permit small operators to rely on consolidated financial

information, and the substantial reduction in administrative burdens is wholly consistent with Congress' concern that the FCC reduce such burdens for small systems. We suggest, therefore, that small system operators be permitted to use whatever consolidated accounting methods they had as of April 1, 1993, the date the FCC adopted its rate regulation Report and Order.

Finally, the Coalition urges the FCC to retain a definition of "small system" that will protect from undue burdens those systems that can least afford to shoulder them. To this end, we recommend that "small systems" be defined as those systems with less than 1,000 subscribers, regardless of ownership. The short answer is that Congress mandated the Commission to minimize the regulatory burden on all small systems of 1,000 or less subscribers. We respectfully submit, therefore, that the Commission does not have the discretion to define "small systems" in some other way. See, e.g., American Civil Liberties Union v. FCC, 823 F.2d 1554 (D.C. Cir. 1987).

Moreover, as will be more fully described in the Coalition's Comments to be filed August 31, 1993, in response to the Further Notice of Proposed Rulemaking, regardless of ownership, systems with less than 1,000 subscribers have the same administrative burdens and often operate with slimmer margins than larger systems due to their high costs per subscriber. Because the number of subscribers at the system level has such an impact on per subscriber costs, this should be the variable that defines those "small systems" entitled to relief from administrative burdens.

The administrative burdens resulting from new FCC regulations may even be worse for multiple system operators with small systems than for independently owned small systems. For example, for an operator like Douglas Communications, with 428 headends with less than 1,000 subscribers serving an

average of 191 subscribers, the burden of completing one Form 393 -- which the FCC estimates to take 40 hours 37/ -- for each of the systems 38/ would require one person to work full-time for over a year. Assuming that the person completing the forms was paid $20.00 per hour, the cost per subscriber for the average Douglas system with less than 1,000 subscribers would be $4.19 per subscriber. Taken together, the cost of preparing Form 393s, complying with signal carriage rules, implementing new customer service standards, improving technical facilities pursuant to new standards, and complying with other facets of rate regulation, will quickly overwhelm the revenue generated by many small systems.

The severe impact of additional administrative burdens and the tighter operating margins for small systems resulting from high per subscriber costs clearly distinguish small systems from larger ones. And, in the final analysis, the total number of subscribers and subscribers per mile are the two most critical factors defining small systems. That a system is commonly owned with other small systems simply does not meaningfully impact on the individual system's ability to take advantage of meaningful economies.

VI. The Cost-of-Service Models Will Ease The Burden On Cable Operators and Franchise Authorities.

Tony Kern, a Senior Manager of Arthur Andersen & Co., has developed cost of service models -- one to be used by large system operators (Exhibit

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37/ In contrast, we estimate that our proposed "net income" form could be completed in less than one hour. And our proposed streamlined cost-of-service form for small systems should take less than three hours to complete.

38/ Even though many of the systems serve multiple franchise areas, each requiring its own Form 393, we conservatively assume here that only one Form 393 will be required for each system.

2), and the other to be used by small system operators (Exhibit 3). 39/ See Kern Declaration attached as Exhibit 1. These models are designed to be used by cable operators seeking to justify their rates in cost-of-service showings. The models are organized into various sections so that cable operators can input various components of the ratemaking formula (operating expenses, rate base and rate of return). Based upon the information provided by the cable operator, the models will produce a figure representing the revenue required for a system's particular service category (e.g., Basic service). If the models identify a total revenue requirement that is higher than the actual revenue for a particular service category, the cable operator then would be entitled to raise its rates. Conversely, if the model identifies a revenue requirement that is lower than the actual revenue for a particular service category, then the cable operator would have to adjust its rates.

Allocations. Mr. Kern's cost-of-service models allow operators to input certain revenue and cost data, as well as system characteristics. Revenues are allocated by the cable operator according to its revenue sources. Expenses are allocated directly by the operator or automatically by the models on the basis of the proportion of revenue or the number of subscribers. Marketing expenses are allocated by revenue, on the assumption that revenue generally "reflects the value of the marketing expense to the cable television system." Corporate expenses are

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39/ The cost-of-service models for both large and small systems are essentially the same in that they operate under the same assumptions, require the operators to input the same type of information, and make the same calculations. The only distinction is that the model developed for the small systems is a streamlined version of the more complex model developed for the larger systems. In an effort to relieve some of the administrative burden on small systems, and in recognition of the fact that small systems most likely do not have as sophisticated accounting records as larger systems, the model for small systems identifies more general, albeit as inclusive, categories of operating expenses.

allocated based on the number of subscribers. Operations expense is allocated primarily to basic service because the network is constructed and maintained primarily to deliver basic service. Depreciation and amortization expenses are directly allocated by the operator. Mr Kern believes that generally these latter expenses should be assigned to basic service. He notes that "[t]he FCC has used this 'building block' approach in its treatment of equipment charges in its benchmark calculations," and he believes it is appropriate to assign these expenses to "the basic service that all subscribers must obtain (by Congressional mandate) before taking any other services." Kern Declaration at p. 4.

Rate Base. The models include in the rate base the cost of the system's tangible assets, any unrecovered early start-up costs, and the interest necessary to carry these amounts until the system reaches profitability. The models depreciate and amortize these amounts over 12 years, the useful life of cable physical plant, which Mr. Kern also establishes as the typical investment cycle. The models restate the system's depreciation on a straight-line basis. Where the cable operator has purchased the system (or a portion thereof) or where original cost information is otherwise unavailable, the models calculate an industry-average reproduction cost for the system based on various factors -- miles of plant, the number of channels, whether the system is urban or rural, whether the system is underground or aerial, and how many homes are passed per mile. Reproduction cost is then depreciated -- on a 12-year, straight-line basis -- to reflect the actual average age of the system. The models also calculate the deferred start-up costs for such a system based on the number of subscribers, current penetration, system density, miles of plant, and average revenue per subscriber. The models then add an interest component to cover the construction costs and start-up losses during the period

prior to the cable operator breaking even. These amounts are added to the rate base and amortized over 12 years.

Rate of Return. Mr. Kern does not recommend any particular rate of return. He believes that the cable operator, at least in the first instance, knows best what returns on debt and equity are necessary to continue to attract investment. He also understands that different types of systems bear different risk factors, have different borrowing rates, and require different levels of equity returns to attract investors. 40/

VII. Conclusion.

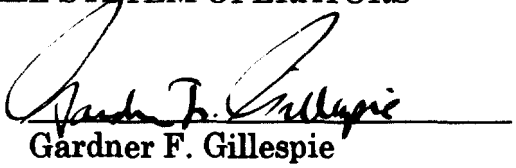
We urge the FCC to adopt cost-of-service standards that permit cable operators ultimately to recover all of their investment. The Constitution requires nothing less. Specifically, we urge the FCC to adopt cost-of-service standards that will allow cable operators, who built or rebuilt their systems, to include in their rate base (1) the depreciated original cost of their plant and equipment, (2) all deferred (unrecovered) expenses during the start-up phase, (3) all deferred (unrecovered) interest payments on borrowed funds to meet these costs, (4) all deferred (unrecovered) depreciation, and (5) all budgeted capital expenditures for the ensuing twelve months. We also urge the FCC to adopt cost-of-service standards that will allow cable operators who acquired their systems following construction to justify their rates, as a transitional matter, by including in their rate base the full acquisition cost of their cable system depreciated and amortized to the present date. Moreover, at an absolute minimum, to allow cable operators to justify current rates or a rate increase, the FCC should allow cable operators to include in their rate bases (1) that portion of the acquisition cost that represents the full (reproduction)

40/ Mr. Kern's models are attached as Exhibits 2 and 3. The diskettes on which the models are based will be made available to the Office of Plans and Policy.

cost of building their system (less depreciation reflecting the system's age) plus all of the start-up expenses the cable operator would incur in achieving a positive net income, and (2) that portion of the acquisition cost associated with saved expenses resulting from operating efficiencies. We also urge the FCC to adopt the cost-of-service models attached hereto to ease the burdens on cable operators and franchise authorities during cost-of-service showings. Finally, we urge the FCC to adopt a streamlined cost-of service model for small systems, and to permit small systems to rely on a simplified "net income" analysis to avoid further regulation if their gross revenues as a percentage of operating expenses, depreciation, and interest expenditures, do not exceed 15.5 percent.

Respectfully submitted,

PRIME CABLE, HARRON COMMUNICATIONS CORP., GEORGIA CABLE PARTNERS, ATLANTA CABLE PARTNERS, L.P., WOMETCO CABLE CORP., AND THE COALITION OF SMALL SYSTEM OPERATORS

By 

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Dated: August 25, 1993

DECLARATION

I, Anthony P. Kern, hereby declare under penalty of perjury that the following statements are true and correct:

I am a Senior Manager in the worldwide Telecommunications practice of Arthur Andersen & Co. My primary area of expertise is cable television operations, management, valuation, and economics. I have engaged in numerous studies of the operations, valuation, competition, and construction of cable television systems for virtually every type of cable television system that exists in the United States. I have personally visited over 2,000 cable television systems during my career and directed consulting applications for nearly 6,000 cable television systems. I have given testimony as a cable television expert, under oath, in several U.S. Federal Courts. My resume of professional experience is attached.

At the direction of the law firm of Hogan and Hartson I have developed two cost of service ("COS") models for use by cable system operators, one for use by large system operators (1,000 subscribers or more) and one for use by small system operators (less than 1,000 subscribers). The small systems COS model is a streamlined version of the more complex model developed for the larger systems. Both models are designed to help cable television operators organize their accounting records into a simple format that will produce COS revenue requirements based on a rate base/rate of return methodology that is grounded in traditional cost-of-service concepts.

The COS worksheets are organized into various sections which enable input of the major components of the ratemaking formula, operating expenses, rate base and rate of return. The worksheets are designed to make allocations of revenues and expenses between the various cable services - basic, Cable Program Services ("CPS"), pay, additional outlets, equipment, etc. The worksheet culminates in a service category revenue requirement and comparison to current revenue.

How the Worksheets Operate

Revenue Items

The top section of Worksheet I allows the entry of revenue, subscriber and channel information by service category. This information will be used in the expense allocation process. Ultimately, the revenue portion will be compared to the revenue requirement developed by the model. The revenue amounts entered should reflect the actual amount of revenue gathered during the test period for the service category. Any adjustments should be made in the appropriate column. The subscriber inputs should reflect the actual number of subscribers for the test period for each category of service -- basic, CPS, pay, additional outlets, and converters (if appropriate). The channel inputs should be the actual number of channels activated and dedicated to use for the particular service category (basic, CPS, pay, pay-per-view). For large systems, the expenses fall into these six categories but include more detail.

Operating Expenses

The bottom section of Worksheet I is for entry of operating expenses. For small systems, the operating expenses are organized into six categories - Basic programming expense, pay programming expense, operations, marketing, general and administrative and corporate allocation. The worksheet is designed for direct entry of these operating expenses in the first column. All expenses necessary to the provision of cable service are entered. For simplification (for small systems), we have consolidated all expense into these six operating categories. Generally, for both large and small systems each category would include the following expenses:

Basic Programming - All expenses related to the provision of basic and CPS service including programming fees, copyright charges, local origination expenses, and institutional network program costs.

Pay Programming - All expenses related to the provision of pay and pay-per-view services. Specifically, programming fees.

Operations - All expenses related to the technical operations of the system including technicians wages and benefits, system powering and maintenance costs, vehicle expense, expense for small tools, pole attachment fees, repairs, site rentals testing, engineering, and other network related expenses.

Marketing - All expense related to the advertising and marketing of the system services including promotional items, wages, and benefits.

General and Administrative - All expenses related to the administration of the system including wages and benefits not previously reported for client service representatives, managers and staff, accounting and legal, rent, franchise fees, insurance, health insurance, computer systems, taxes, postage, etc.

Because there is no uniform chart of accounts for the cable television industry and different companies classify expenses differently, it is necessary to identify items that are similar to the expense categories listed and to consolidate them into the appropriate expense category. One item of note deals with bad debt expenses. If this information is available, it should be input to develop a relationship of these expenses to revenue. They are included in the revenue gross-up calculation. The second column of the worksheet is provided for normalization adjustments. Normalization adjustments are used for the removal of unusual or one time costs.

Depreciation and Amortization - The additional categories of depreciation and amortization are included at the bottom of Worksheet I. The models recalculate the annual depreciation and amortization expenses based on inputs from Worksheet II. For systems or those portions of systems built (or rebuilt) by the operator, the model assumes an average useful economic life of 12 years from the year of construction. (See below.) The model also assumes that the cycle of investment mirrors the average 12-year economic life of the tangible assets. The model restates depreciation and amortization on a straight-line basis. The economic life of an assset is a composite of its actual useful life and technological life.